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Tax expenditures managing organized confusion
(Discussion paper no. 55)

Office of the Auditor General of Canada

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DISCUSSION PAPER NO. 55

TAX EXPENDITURES MANAGING ORGANIZED CONFUSION

by

T. Koplyay, B. Elkin, J. Hood

February 1986

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TAX EXPENDITURES

Managing Organized Confusion

Objective

This paper attempts to shed some light on the role of tax expenditures in Canada's taxation system. The main objective of the paper is to stimulate discussion on the subject of tax expenditures by pointing out why they exist, the effects they have on the basic taxation issues of fairness and simplicity and the audit issues that arise concerning accountability to Parliament for their costs and management. The discussion of this non-traditional audit area assumes some basic knowledge of economics and public finance. Although the concepts discussed are not difficult, they do require extra attention by the reader.

Introduction

Tax expenditures are just one of many ways for the government to intervene in the private sector economy for the purposes of pursuing social policy. Examples of some other means are direct expenditures, regulatory regimes and Crown corporations. The accountability framework for parliamentary control is adequately defined today only for direct expenditures; some progress on Crown corporations has been made through the recent amendments to the Financial Administration Act.

The Office has traditionally pursued VFM audit work in the direct expenditure area. Recently, however, we began to examine more closely Crown corporations and, under the expanded mandate set out in the FAA, we are preparing for a more active audit role. In contrast, the taxation system has received very little attention from this Office to date, probably because there are no published numbers to audit. Nevertheless, the Auditor General raised some concerns about tax expenditures in the 1984 report.

This paper examines the presence of tax expenditures within the taxation system and the accountability issues that may be of further interest to the Office.

Background

Government intervention in the economy is motivated by three major objectives that have evolved from the basic assumptions and prescriptions of Keynesian economics. To further its social policy through economic means, the government relies on the macro-economic functions of allocation, distribution and stabilization.

Under the allocation role, the government influences the investment patterns in productive capacity and the actual output of goods and services.

The distribution role is exercised to ensure the transfer of economic wealth among social groups as dictated by the political realities of the day and the basic notions of social justice endorsed by the electorate.

The stabilization function is exercised to minimize the extremes of the cyclical swings in the economy that are inherent in a free market system.

To achieve these politically defined economic objectives, the government has several modes of intervention available. It can influence economic input or output through budgetary outlays. It can also pass laws and regulations with appropriate sanctions and policing powers to compel certain behaviour patterns. Alternatively, it can participate directly on a quasi-competitive basis in the market through the proxy of Crown corporation activities. It can also influence market response through the taxation system by offering incentives or disincentives targeted at particular groups and seeking specific responses.

Tax measures designed to elicit specific social or economic behaviour are referred to by most authors on the topic as tax expenditures. These tax

expenditures can focus on individuals and corporations and can range in purpose from the assurance of adequate retirement funds to the encouragement of specific investments, such as R & D.

Through the taxation mode, corporate and individual decisions to invest, save or consume can be influenced. The cumulative effect of such decisions leads to a different economic profile than would have prevailed without the presence of taxes. Hence, the government's purposes of reallocating production means or levels, redistributing national wealth and controlling the amplitude of economic ups and downs are abetted by taxation policy.

Within this policy, tax expenditures are a major tool, continually reinforcing grand economic objectives at the practical level of the individual participant in the economic process. In a very real and, to some people, alarming sense, these tax concessions are expenditures inasmuch as they represent revenue foregone by the government. In many cases, tax expenditures could be replaced by budgetary ones and conversely. Consequently, an equivalent effect should be measurable on the net financial position of the government.

The Taxation System and Tax Expenditures

The taxation system has a twofold purpose. One is to effect government social and economic policy and the other is to raise revenues for government to implement its policies and to pay the interest for the imbalance between past needs and means. (This last item is the national debt.)

The government has access to other sources of revenue such as debt creation, printing money or the profits of Crown corporations. However, most Crown corporations lose money and the other two means are either inflationary in nature or represent postponed payment obligations. In both cases they are just "play now pay later" solutions that the average individual, without access to government financing devices, could not pursue for long.

(This issue by itself represents an interesting accountability dilemma: to what extent do present governments have the right to impose debt obligations on future generations of voters, who have no say in the matter? Taxation without representation has led to interesting altercations in the past. Will the concept of retroactive political accountability for the exercise of taxation rights ever surface?)

An item often overlooked is the high stakes that federal taxation policies represent to the provinces. With a few exceptions, provincial tax revenues are linked on a percentage basis to federal tax revenues collected or to taxable income as defined under the Income Tax Act. Raising accountability issues in this area can readily assume constitutional dimensions. Our immediate concern though is with the federal situation and its implications.

There are a few key assumptions underlying the design of our taxation system. To operate on the basis of self-assessment and voluntary compliance, the system must be perceived by the taxpayer as fair and equitable. In other words, the tax burden should be borne and be seen to be borne equally by all. This implies under our system of progressive rates, that each group of taxpayers contributes a fair share of its income and that within the same group, taxpayers in similar income situations pay equal taxes. Such a system should normally encourage voluntary compliance.

From the perspective of those who make tax rules, there are also features that can make life easier. Rules of taxation should be simple to assist the process of self-assessment by the taxpayer. The system should be accessible in the sense of alerting taxpayers to their tax duties and privileges. Furthermore, it should guarantee with some reasonable certainty a level of revenue necessary for funding government programs. Practical considerations also dictate a reasonably assured cash flow to the government for ongoing expenditures. This last requirement may have led to the practice of deductions of income taxes at source.

To maintain the basis of the private sector decision-making rationale, the tax system also strives, at least in theory, to remain neutral in its effects on the relative price structure. Whenever feasible, it should minimize distortions caused by its inherent characteristics favouring some activities, thereby penalizing others.

An example is the sales tax. A specific commodity sales tax on cigarettes is not neutral because it changes the price of this item relative to other goods. A general sales tax is more neutral because it affects all goods at the same time. (Even a general sales tax may be flawed from a higher neutrality perspective when one further considers that a disincentive to consumption -- the sales tax -- may unproductively favour excess savings in the economy.)

To recognize real life conditions in the taxpayer's "ability to pay", the tax system provides for a series of exemptions, allowances, deductions and tax credits. (A path through the taxation jungle is provided by Chart 1.) These adjustments exist to equalize the differences between different taxpayer units that should be considered to have equal earning power and hence be subject to equal tax obligations. For this reason families are allowed deductions for dependents, older people get certain exemptions, divorced people receive child support deductions and so forth.

These measures ensure that the taxpaying unit, if it is a family or an individual with special needs, is not penalized. Further adjustments are available for income averaging purposes. Because income earning capacity and actual income flow are not always in tune with taxation years, income flows with high fluctuations would be unfairly taxed under the progressive rates.

When the exemptions, deductions, allowances and credits reach beyond the intent of fairness or equity and are devised primarily to elicit some economic response from taxpayers, they become true tax expenditures. The scope of these devices is mind-boggling. A partial list includes: Registered Retirement Savings Plans (a long-term income averaging provision), Investment Tax Credits, Scientific Research Tax Credits, Registered Home ownership Savings Plans,

Multiple Unit Residential Buildings and a host of other goodies directed at the natural resources extraction industry. A list published by Finance in 1980 identified 158 tax relief measures out of which we would consider 83 to be tax expenditures.

The total bill to the government in foregone revenue, depending on whose yardstick one goes by, was between $30 billion and $50 billion in 1980. This represents, at the midpoint, approximately 50% of total budgetary outlays.

The definition of tax reliefs and expenditures is closely linked to the notion of the tax base. Depending on what is or is not taxed, a particular measure may or may not be a tax expenditure. For example, if we go by our system of income taxation, measures that encourage increased savings are tax expenditures because the government is willing to forego tax revenue in exchange for higher savings resulting from taxpayer contribution to some registered tax shelter. If we had taxation of consumption, no wealth would be taxed until consumed. Hence, by definition, savings would be tax exempt until they entered the economic cycle as consumption. If savings are further viewed as deferred consumption, then savings, in this case, represent income averaging to the government; some time or other, savings are consumed and hence taxes are due. A change in tax base from income to consumption would entail major changes in revenues generated through sales taxes as well and would affect the certainty of receipt and hence the methods of assessment and collection.

Many experts have argued that the taxation of corporate dividends or, for that matter, the taxation of any corporate activity is double taxation in view of the fact that the owners of the corporation are also individual taxpayers.

Obviously what is being taxed has as important a consequence as who is being taxed.

One of the major dilemmas of designing a satisfactory taxation system is the inherent conflicts among three of the key design principles. As discussed, the taxation system is used simultaneously to generate revenue for the

government and to deliver social and economic programs. It attempts to do both while striving to remain simple, fair and equitable. This is a hopeless task.

The presence of tax expenditures complicates the system and drives it from its equilibrium of perceived fairness and equity. When the taxpayers at large see the endless parade of tax breaks directed at some privileged group, their inclination to comply voluntarily will diminish in the long run. Furthermore, the net cumulative effect of all tax expenditures may be just a decrease in tax revenues to the government. After all, if every wealth-generating economic group is given investment tax breaks, the effect is to favour no one in particular from the investment attractiveness perspective, but simply to increase all available deductions and consequently decrease the taxable income base.

Many reasoned arguments have been put forth by experts that the closing of most tax loopholes (expenditures), would not only result in more government revenues but would be more economical, efficient and effective.

These issues of macro effectiveness and efficiency of government programs have never been pursued by this Office. Given their effects on the economical use of government moneys, a good close look is warranted.

How Are Tax Expenditure Programs Managed?

Tax expenditure proposals can arise from two basic sources: through line department sponsorship or, more likely, as an initiative of the Department of Finance. If they are proposed by line departments, they are automatically subjected, to some extent, to the budgetary discipline of the envelope system. The cost of the program is forecast and the envelope is adjusted accordingly. Consequently, some fiscal responsibility is automatically built into the system. (The forecasts though are seldom challenged or subsequently verified, and therefore many important residual accountability issues remain. As far as we know, envelopes are not retroactively adjusted for under estimated tax expenditures.) If Finance is the author of the proposal, even this deficient fiscal safety check is by-passed. In either case, if the tax program forecast costs are

off base, no adjustments are available and any "low balling" of costs results in increased government deficits in the sense that more revenue is foregone by the Treasury than was foreseen, and such shortfalls may have to be made up by increased borrowing or decreased direct expenditures.

Regardless of how the tax expenditure is proposed, once approved through a Ways and Means Motion to amend the Income Tax Act, it assumes a permanent character. From an auditor's viewpoint, therefore, tax expenditures are like statutory programs. Their life cycle is indefinite and unknown.

Once the program has been approved by Parliament through a specific amendment or series of amendments, the administration is turned over to Revenue Canada - Taxation. Not having had a lot to say about the program's content or administrative feasibility, Revenue Canada - Taxation goes about the business of delivering the program as best it can.

When taxpayers, through their own ingenuity or with the help of high priced talent, discover the potential for use and abuse of the program, an interesting phenomenon begins to develop. The taxpayer's affairs are restructured to take advantage of the new tax provision. Often this is feasible without a significant contribution by the taxpayer to the stated objectives of the program. This response falls into the category of tax avoidance. It is perfectly legal for the individual but, from the financial and policy viewpoints, it is painful to the government. Usually, Revenue Canada - Taxation gets an idea of the practice through its advance rulings division. This is where taxpayers with doubts about the legality of their tax schemes may go for a ruling. Only naive and upright taxpayers or those having to assure their investors follow this route. Those with more dubious plans prefer to keep the details of the scheme to themselves and let the government find out about it if it can.

The normal course of action for advance rulings is to judge the proposed tax scheme against the letter of the law. In other words, the contribution of the taxpayer to the program objective is seldom considered unless the avoidance mechanism is so blatantly counter-productive to the intent of the

tax provisions that it cannot be ignored. (This was finally faced in the termination of the Scientific Research Tax Credit program after the tax revenue loss of almost $2 billion.) If requests do not pass through advance rulings for opinions, then Revenue Canada - Taxation must rely on normal audit procedures to police compliance. Given that the coverage provided by Revenue Canada - Taxation for the taxpayer population as a whole fluctuates between 1 per cent and 3 per cent and is decreasing, people playing the tax lottery game of evasion and avoidance based on a generous interpretation of the self-assessment rules can reap interesting payoffs. To complicate matters, Revenue Canada - Taxation is not normally capable of auditing on a tax expenditure program basis. Hence the efficiency of program uptake, effectiveness of program measures and total program costs can and do remain forever shrouded in mystery. This should be of some concern to parliamentarians. In our audit work leading to last year's note on the Scientific Research Tax Credits, we have charted the actual process of management against what a reasonable manager may expect to perform if charged with designing and implementing a tax program. Chart 2 summarizes the result for this program: every one of the management functions examined had some serious shortcomings. Compared to tax expenditures, the management of direct expenditure programs approaches textbook perfection.

What are the Issues?

To examine the significance of the issues involved, one has to look at the life cycle of the typical tax expenditure.

We can use as a visual reference the Tax Expenditure model of Chart 2. It is worthwhile to keep in mind the major concern with tax expenditures -- accountability to Parliament. At the most rudimentary level, parliamentary accountability requires four essential steps.

First, the information on which a parliamentary decision is requested should be relevant, complete and accurate, or at the very least reasonably reliable. Second, the responsibility assigned by Parliament for carrying out the various management tasks should be unambiguously assigned. Responsibilities for

implementation and control should be backed by appropriate authorities. Third, reporting relationships, frequencies and topics should be determined in advance. Fourth, tax programs should be evaluated at significant milestone of their lifecycles and the results reported to appropriate accountability levels, including Parliament.

All of this sounds so obvious as to border on the comprehensive auditor's "must check" list. In our audit work leading to last year's note on the Scientific Research Tax Credits, we noted that the elementary steps of accountability were either missing or were so faintly present as to be practically non-existent. Program cost estimates were projected only a couple of years into the "eternal" life cycle. These estimates were just guesses with no provisions for adjustments. Consultations leading to the proposal were biased to the extent that only users of the tax breaks were consulted on future courses of action. Invariably and not surprisingly, most recommendations arising out of these consultations dealt with increasing the scope and cost of programs. The program proposal did not evaluate the effects of the proposal on the total tax system or independently put forth evaluation questions that would have to be answered later to assess program effectiveness.

Responsibility for tax programs is assigned between Finance and Revenue Canada - Taxation with the former designing the program and the latter implementing it. Very little incentive remains to design manageable and controllable programs. Evaluations were not carried out because it appears the two departments involved assumed it to be the other's responsibility. If evaluations were to be performed, some interesting lists of questions could be analysed. Some potential questions would be:

- What are the total costs and benefits of the program to date?

- What were the fiscal year expenditure patterns?

- Who benefited from the program?

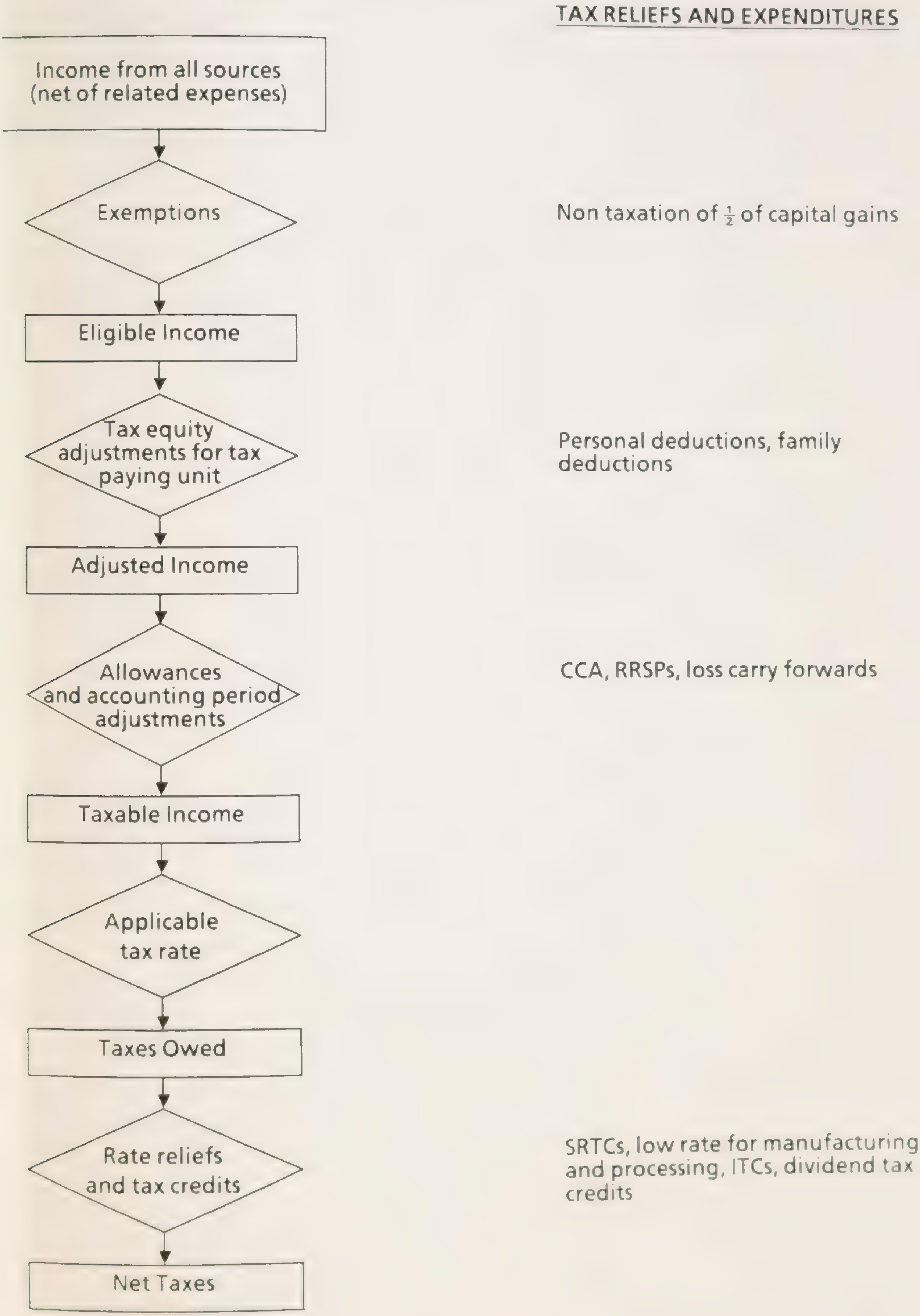
- What was the uptake rate and was the program properly focused and targeted?
- How reliable were program forecasts and analytical assumptions on which program was authorized?
- What were the side effects of the program on the tax system's fairness and equity objectives?
- What was the throughout efficiency of the program? (That is, for every dollar invested by the government, what was delivered to the taxpayer?)
- What was the economic leverage effect? (That is, for every dollar reaching the taxpayer, what were the matching funds provided by the taxpayer?)
- How economical was the tax program compared to other available tax or direct expenditure alternatives?
- How effective was the program in making progress toward objectives?

A cherished assumption about tax expenditures is that they are costless administratively compared to direct expenditures. Nothing could be further from the truth. A tax program has to be designed, implemented, controlled, assessed, audited and enforced. Each of these functions can absorb large funds. (The operating budget for Revenue Canada - Taxation in 1984-85 was $670,515,000). Revenue Canada - Taxation further estimates that follow-up on the cancelled Scientific Research Tax Credit program has already cost around $20 million. Furthermore, given the low level of audit coverage by Revenue Canada - Taxation, we can only guess at the losses incurred by the Crown because of tax avoidance and/or outright fraud. (Tax avoidance can be considered to be present and unacceptable to Revenue Canada - Taxation if the taxpayer's aggressive

interpretation of the legislation conflicts, in the opinion of the Department, with the intent of the legislation. This vast scope for interpretive maneuvering by the taxpayer along with evasion necessitates policing the Income Tax Act.) Losses can also be incurred by the government when back taxes are not paid because of business failure. These losses are analogous to bad debt provisions in the private sector. If the particular tax expenditure program is so generous as to eliminate reasonable business risk, then one can expect some irresponsible business behaviour and the consequent penalty of business failure. These failures in turn lead to "bad debts" to government in tax losses. As one sceptic suggested, the tax programs are cheaper to administer because they are not administered.

Yet, if the comparison to private sector practices and functions is further pursued, one can easily draw an analogy between tax expenditures by government and private sector investment plans. Budgetary outlays correspond to operating funds, and tax expenditures represent long-term "investment" commitments by the government. It is unlikely that private sector investment decisions would be made on such scanty and unreliable information as is presented to parliamentarians on tax proposals. The same applies to the adequacy of controls for implementation and assessment. We are not suggesting including "hurdle rates" in the needs analysis of tax proposals, although this could be a good practice for fiscal discipline, but rather that tax expenditures clear the accountability hurdles that other government direct expenditure programs have to contend with. This entails an in-depth review of the need for a budgetary process for tax expenditure proposals and the development of an appropriate set of program controls to suit the characteristics of their expenditure life cycles.

CANADIAN INCOME TAX SYSTEM



TAX EXPENDITURES PROGRAM MODEL

Chart 2